DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 99-0247
Income Tax
For Tax Years 1994 through 1997

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superceded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Adjusted Gross Income Tax— Business Income v. Non-business Income

Authority: *The May Department Store Co. v. Indiana Dept. of State Revenue*, 749 N.E.2d 651 (Ind. Tax Ct. 2001)
IC 6-3-1-20; IC 6-3-1-21
45 IAC 3.1-1-29; 45 IAC 3.1-1-30

Taxpayer protests the auditor's reclassification of business income as non-business income.

II. Adjusted Gross Income Tax— Income of Corporate Partners: Unitary Operations

Authority: *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 102 S.Ct. 3103 (1982); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992); *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 103 S.Ct. 2933 (1983)
Hunt Corp. v. Indiana Dept. of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999)
45 IAC 3.1-1-153; 45 IAC 3.1-1-153(b)

Taxpayer protest the auditor's determination that taxpayer is not operating in a unitary relationship with its partnership.

III. Tax Administration—Abatement of Penalty

Authority: IC 6-8.1-10-2.1(d)
45 IAC 15-11-2; 45 IAC 15-11-2(c)

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana corporation which operates various businesses. Taxpayer's agricultural division rents farm land, engages in grain and hog farming, owns citrus groves, and owns an interest in a citrus processing entity. Taxpayer's motel division owns a motel in Indiana and an interest in a real estate development in Florida. Taxpayer's prairie division also engages in the rental of farm land. Taxpayer's financial division manages financing arrangements, debt management, and asset management through stock and debentures. Taxpayer administers all of its business endeavors from its Indiana location.

The Department of Revenue conducted an audit for the years in question, and issued various tax assessments against taxpayer. Additional facts will be supplied as necessary for discussion.

I. Adjusted Gross Income Tax— Business Income v. Non-business Income

DISCUSSION

One of taxpayer's significant sources of income is its proceeds from the sale of a certain stock. Taxpayer classified the proceeds from the sale of the stock as business income, which subjected the gains to apportionment and taxation by Indiana. *See* IC 6-3-1-20. The auditor reclassified the sale of the stock as non-business because the auditor found that the income was derived from property formerly used to produce non-business income. The auditor's reclassification made the gains allocable to and taxable by Indiana. *See* IC 6-3-1-21.

"Business income" and "non-business income" are defined by the Indiana Code as follows:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.

IC 6-3-1-20. "Non-business income", in turn, "means all income other than business income." IC 6-3-1-21. For the purpose of calculating an Indiana corporation's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three-factor formula, while non-business income is allocated to Indiana or another state. *See The May Department Store Co. v. Indiana Dept. of State Revenue*, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001).

In the recent decision of *May Department Store Co.*, the Indiana Tax Court determined that in passing IC 6-3-1-20, the General Assembly provided two tests for determining whether income is business or non-business in nature: a transactional test and a functional test. *Id*. at 662-663. Under the transactional test, gains are classified as business income when they are derived from a transaction in which the taxpayer regularly engages, *i.e.*, the particular transaction giving rise to the income is measured against the frequency and regularity of similar transactions and past practices of the business. *May Department Store*, 749 N.E.2d at 658-59. Under the functional test, the gain arising from the sale of an asset will be classified as business income if the acquisition, management, and disposition of the property generating income constitutes an integral part of the taxpayer's regular trade or business operations. IC 6-3-1-20. Following the court's instruction, we now examine whether the gains generated by taxpayer's sale of the stock constitute business income under either of the two tests.

The court instructs us to look to 45 IAC 3.1-1-29 and 45 IAC 3.1-1-30 for guidance in determining whether income is business or non-business under the transactional test. 45 IAC 3.1-1-29 states in pertinent part that, "Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business." 45 IAC 3.1-1-30 provides that, "[f]or purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression 'trade or business' is not limited to the taxpayer's corporate charter purpose of its principal business activity." "A taxpayer may be in more than one trade or business, and derive business therefrom depending upon but not limited to some or all of the following:

> (1) The nature of the taxpayer's trade or business.
>
> (2) The substantiality of the income derived from activities and transactions and the percentage that income is of the taxpayer's total income for a given tax period.
>
> (3) The frequency, number, or continuity of the activities and transactions involved.
>
> (4) The length of time the property producing income was owned by the taxpayer.
>
> (5) The taxpayer's purpose in acquiring and holding the property producing income."

45 IAC 3.1-1-30. From the above language, it is apparent that the criteria to be used in determining a taxpayer's trade or business is not limited by what the taxpayer purports its business to be, but rather on what the particular facts and circumstances show.

Taxpayer asserts that the sale of the stock has always generated business income for taxpayer. According to taxpayer, taxpayer regularly sells off a portion of the stock to generate working capital for its citrus operations, and has done so for a number of years. In support of its assertion, taxpayer presented the following supporting evidence at hearing: (1) taxpayer's acquisition and disposition of the stock has been a constant part of taxpayer's business since 1988 in that the gains from the stock are used as working capital in taxpayer's citrus operations; (2) the sale of the stock provides taxpayer with a large amount of working capital annually that is invested in taxpayer's citrus operations; (3) taxpayer acquires and disposes of an average of 40,000 shares of stock each year, and has done so each year since 1988; (4) the shares of stock are held for relatively short periods of time; and (5) taxpayer's purpose in acquiring, holding, and disposing of the shares of stock is to generate cash that is reinvested in taxpayer's citrus operations.

The evidence of record substantiates that taxpayer's capital gains from the sale of the stock constitute business income. Taxpayer's sale of stock was not a one-time event. Rather, the sale of the stock has been an ongoing occurrence since 1988. The gains from the sale of the stock are used directly as working capital in taxpayer's citrus operations. The sale of the stock is initiated in taxpayer's Indiana offices. The decisions as to how much stock to sell and when to sell it are decisions made at taxpayer's Indiana offices that directly impact taxpayer's business operations. It is irrelevant that the income resulting from the gain from the sale of the stock did not derive from one of taxpayer's principal businesses, *i.e.*, farming and citrus processing. The sale of the stock directly impacted taxpayer's business operations and was clearly frequent and continuous. Moreover, the proceeds therefrom were used directly as working capital in taxpayer's primary business.

FINDING

Taxpayer's protest is sustained.

II. Adjusted Gross Income Tax— Income of Corporate Partners: Unitary Operations

DISCUSSION

Taxpayer and a group of Florida citrus growers are partners in a partnership (the "Partnership"). The Partnership is in the business of growing, harvesting, and processing citrus into juice, as well as marketing and selling the citrus juice. The auditor disallowed the classification of taxpayer's share of Partnership losses as a business loss, and instead classified the losses as a non-business loss. Taxpayer claims that the losses are a business loss, and that it is operating in a unitary relationship with the Partnership. By establishing that the loss is a business loss and that taxpayer is in a unitary relationship with the Partnership, taxpayer is hoping to evince that the loss is subject to apportionment rather than allocation.

In order to determine how the income (or loss) from a corporate partnership is to be attributed, it must first be determined whether that income constitutes business or non-business income from the point of view of the taxpayer. *See* IC 6-3-2-2. The first step in this analysis is ascertaining whether the taxpayer and the partnership are engaged in a unitary business or not. *Hunt Corp. v. Indiana Dept. of State Revenue*, 709 N.E.2d 766, 776 (Ind. Tax Ct. 1999). If the income from the Partnership constitutes business income (*i.e.*, if taxpayer and the Partnership are engaged in a unitary business), under IC 6-3-2-2, then that income would be subject to apportionment based on an application of the Partnership's property, payroll, and sales factors. *Id*.

The Indiana regulations more specifically address how to treat a corporate partner with respect to partnership income. *See* 45 IAC 3.1-1-153. This regulation is also determinative of how to determine whether or not a unitary relationship exists. 45 IAC 3.1-1-153(b) reads in pertinent part that if a "corporate partner's activities and the partnership's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of the unitary business attributable to Indiana shall be determined by a three (3) factor formula . . ." This section indicates that to establish the existence of a unitary operation, the taxpayer must demonstrate that the relationship between itself and the partnership meet the established characteristics of a unitary relationship.

The unitary principle is addressed repeatedly by the Supreme Court; and, while no single definition exists, one characteristic appears to be essential – day-to-day operational control. *See*, *e.g.*, *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 102 S.Ct. 3103 (1982); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992); *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 103 S.Ct. 2933 (1983). Here, to establish that a unitary relationship does in fact exist, taxpayer must demonstrate at the very least that taxpayer has operational control of the Partnership or that management of the Partnership is centralized with the management of the corporation.

In the instant case, the auditor found that the Partnership was not unitary with taxpayer and the losses were not business losses because, *inter alia*, taxpayer owned less than a twenty-five percent (25%) ownership interest in the Partnership. It is true that taxpayer has a twenty percent (20%) ownership interest in the Partnership. However, in determining whether income (or losses) is business or non-business, the Department does not consider the percentage of ownership. See 45 IAC 3.1-1-153(b). The Department looks to whether the income is acquired in the regular course of the taxpayer's trade or business operations. IC 6-3-1-20.

Taxpayer is a corporation which engages in various operations as part of its regular business activities, including active participation in a partnership that is in the business of growing, harvesting, and processing citrus into juice, as well as marketing and selling the citrus juice. During the hearing, taxpayer presented evidence that taxpayer's owners and shareholders are actively involved in the operational, management, financial, and marketing aspects of the Partnership on a continuous basis. No operational decisions are made for the Partnership without the review and consent of representatives of taxpayer. Taxpayer's chairman, who also serves as chairman of the board of the Partnership, spends an average of sixty (60) hours per month with Partnership managers, officers, owners, and customers. Taxpayer's chairman has the express authority to review, approve, or reject all Partnership budgets and financial decisions prior to implementation.

The evidence submitted by taxpayer establishes that (1) the operations of the Partnership are an integral part of taxpayer's regular business operations; and (2) taxpayer exerts considerable control over the Partnership. We find, therefore, that the losses from the Partnership constitute business losses, and that a unitary relationship exists between taxpayer and the Partnership.

FINDING

Taxpayer's protest is sustained.

III. Tax Administration— Abatement of Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent (10%) negligence penalty.

IC 6-8.1-10-2.1(d) states that if a person subject to the negligence penalty imposed under said section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. 45 IAC 15-11-2 defines negligence as the failure to use reasonable care, caution or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or Department regulations.

In order to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. 45 IAC 15-11-2. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ." 45 IAC 15-11-2(c). In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits. *Id*.

In this case, taxpayer has demonstrated that it exercised ordinary business care and prudence in carrying out its duty to pay income tax. Therefore, taxpayer has affirmatively established reasonable cause, and the negligence penalty shall be waived.

FINDING

Taxpayer's protest is sustained.

HLS/MR-012012